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# THE INTERNATIONAL MONETARY SYSTEM

## The Next Twenty-Five Years

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Symposium at Basle University  
to Commemorate Twenty-Five Years of  
Per Jacobsson Lectures  
June 12, 1988

C. Fred Bergsten  
Sir Kit McMahon  
Tommaso Padoa-Schioppa

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BANK FOR INTERNATIONAL SETTLEMENTS  
PER JACOBSSON FOUNDATION



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## Foreword

A symposium on "The International Monetary System: The Next Twenty-Five Years," jointly sponsored by the Bank for International Settlements and the Per Jacobsson Foundation, was held in Basle on June 12, 1988 to commemorate twenty-five years of Per Jacobsson Lectures. The proceedings of the symposium are presented in this publication. The symposium featured addresses by Sir Kit McMahon, Chairman and Group Chief Executive of the Midland Bank, Tommaso Padoa-Schioppa, Deputy Director-General of the Banca d'Italia, and C. Fred Bergsten, Director of the Institute for International Economics. Sir Jeremy Morse, Chairman of the Foundation, presided over the symposium, and Prof. Dr. Werner Arber, Rektor of Basle University, welcomed symposium panelists and guests to Basle.

The Per Jacobsson Lectures are held annually in recognition of Per Jacobsson's lifelong interest in international monetary cooperation. Per Jacobsson joined the staff of the League of Nations in 1920 to help prepare for the Brussels Financial Conference. At the beginning of the 1930s he moved to the Bank for International Settlements where he became Economic Adviser and Head of the Monetary and Economic Department. Following his BIS service, Per Jacobsson was invited to come to the International Monetary Fund where he served as Managing Director and Chairman of the Executive Board from 1956 to 1963.

Upon his death, several of his friends and admirers felt that a way should be found to commemorate his life. Sponsors from many countries joined in providing the funds for the Per Jacobsson Foundation, which was established in 1964 as an independent forum to promote informed discussion of international monetary affairs. The Managing Director of the Fund and the General Manager of the BIS serve as *ex officio* members of the Board of Directors of the Foundation to mark the interest of the two institutions with which Per Jacobsson was most identified. The lectures were inaugurated in 1964 at Basle University, another institution with which Per Jacobsson had close ties.

The Per Jacobsson Lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.



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# Opening Remarks

*Sir Jeremy Morse*

Ladies and gentlemen, good afternoon. I would like to begin the proceedings of the twenty-fifth meeting of the Per Jacobsson Foundation by asking the Rektor of Basle University, Prof. Dr. Werner Arber, to come and say a few words to us.

*Prof. Dr. Werner Arber*

Mr. President, ladies and gentlemen, it is a great pleasure for me to welcome you here on this Sunday afternoon for the twenty-fifth Per Jacobsson lecture. Indeed, it was twenty-five years ago that after the death of Per Jacobsson the first lecture in his memory was held here at Basle University. This is the sixth such lecture to take place in Basle. The others were held in other important cities. I say in other “important” cities because I regard Basle to be an important city; otherwise I wouldn’t be seeing so many distinguished people, on a Sunday afternoon, in this room. I would like to commend you for all your work. I would also like to thank the Foundation for coming back to Basle to hold these lectures again today as they did twenty-five years ago.

I am a biologist and as I mentioned earlier to some of the speakers and organizers of this symposium, my main interest in biology is biological evolution. I see a similar evolution taking place in human civilization—the cultural evolution. One aspect of this cultural evolution is the topic of today’s symposium, and other aspects have been the subjects of earlier Per Jacobsson lectures. I know it is difficult to give precise answers to questions asked of scientists, whether in the field of biological evolution or of the evolution of monetary systems, so I look forward to hearing what will be said today about the next twenty-five years in your field. In biology we have twenty-five rather difficult years ahead of us, both to make our science better understood by the scientists themselves and to explain our findings to the general public. You have similar tasks, and I think the Per Jacobsson lectures serve these purposes very well.

Before I conclude, I would just like to say that we are, at the university, very glad to have the Bank for International Settlements in our city. We have very good relations with the BIS, and we are pleased that the BIS is associated with many of our activities at the university. Certainly, some of

the deliberations at the BIS in the course of its work flow into the teaching at the university. Our faculty of economics is not large—it is a part of the faculty of philosophy and history. Rather than splitting subjects into different faculties it is perhaps better to keep allied subjects together, since that permits a more intensive communication among the disciplines.

Our economics faculty recently moved to a new building, which is next to where we are now, and the BIS helped us financially to set up these new offices and teaching facilities. So, with great pleasure, I again extend our thanks to the BIS.

I wouldn't like to take up any more of your time, so I just wish you a very fruitful afternoon. Thank you very much.

*Sir Jeremy Morse*

Thank you very much, Rektor, for those charming and pertinent words of welcome. I don't think this occasion has ever before been opened by a distinguished winner of the Nobel prize and we are honored to have you with us. Thank you very much.

The Rektor gave you the history of the Per Jacobsson lectures in Basle. This is the sixth such occasion, and it's very fitting that we come back here for the twenty-fifth because this was the scene of the central part of the career of Per Jacobsson. We are absolutely delighted that two of his three daughters, Birgit and Moyra, are able to be here with us today.

We should also express our thanks to Alexandre Lamfalussy and the BIS for all the arrangements that they have kindly made for the occasion.

We've got a slightly different format for you this afternoon to mark the twenty-fifth. Instead of a formal lecture by one person or supported by some commentators, we have a genuine panel, three speakers, to be followed by I hope a discussion, as well as a question and answer session, because we have a very well-informed audience whenever we meet here in Basle. The order of speaking will be as set out in the little booklet that you have: Sir Kit McMahon, then Dr. Tommaso Padoa-Schioppa, and last of all, Fred Bergsten. I won't go through their biographies. Most of you know them extremely well and those of you who don't, they are well written in the booklet that you have in front of you. Timing is important. They've agreed to speak for between 15 and 20 minutes each, and if we stick to that program, we shall be able to finish that part within the hour and then we will have ample time for, as I said, a discussion and questions.

It has been a tradition to have written questions and you will find that at the back of the booklet you have a little sheet on which you can write your questions, which will come to Jacques Polak, the President, who is sitting at the end, if you wish to do so. But I much prefer that you stand up and say whatever you have to say because that makes for a more real discussion. The speakers will have fuller texts than they have time to deliver and these will be

published in due course. I'll say one more thing. When we met this morning, I urged all the speakers to pay attention to the title of the symposium, which is, "The Next Twenty-Five Years," and I said, "fix your eyes on the year 2013." And I urge you all to do that whether you expect to be here or not! Looking along well ahead is quite hard for human beings so that the perspective tends to come forward. So that's just my one word to you and the speakers—don't forget the title of the session, and with that I ask Sir Kit McMahon to start us off.



# The International Monetary System Over the Next Twenty-Five Years

**Sir Kit McMahon**

It is always enjoyable to talk about the future, but the pleasures of prediction are normally short-lived. The chickens soon start coming home to roost—usually alighting on all the wrong perches. To be asked to look forward twenty-five years, therefore, is unimagined luxury. I am unlikely to be here to be proved wrong; but I am pretty confident I shall be past caring if I am.

It is, of course, an honor as well as a pleasure to be asked to gaze into this distant future by the Per Jacobsson Foundation, which has persuaded so many distinguished people to speak for it in the past. And I am particularly delighted to be able in this way to pay a small homage to Per Jacobsson who was a towering figure in international affairs when I was a young man just beginning to engage in them; and who was the source of many affectionate legends among central bankers in the period when I used to come as one of them, regularly here to Basle.

Now to the task. How does one go about envisaging the evolution of the international monetary system over the next twenty-five years? Well, for me, the first thing is to dispute the formulation. There is a *petitio principii* in the title of today's symposium.

Some years ago, János Fekete on this very platform said that if a wheel fell off your car it was no use re-christening it a tricycle. I agree. Under Bretton Woods, up to 1971 or perhaps 1973, we had an international monetary system. Since then we have not. One important element in the task before us today is, in my view, to assess whether over the next twenty-five years we shall rebuild a system or whether we shall not.

Some may think that to speak like this is logic-chopping, but I disagree. It is not a question of whether what we have had since 1971 is better or worse than what we had before (though I have views on that). In any case, it may be that there was no alternative to what we have had since 1971. But if words are to retain any meaning, an international monetary system must involve some kind of set of rules governing the monetary relationships between nations: in particular, the determination of exchange rates and the nature, convertibility, and acceptability of international assets. The rules may be of many kinds, they may be tight or loose, simple or complex, but they must exist in a form that can be clearly expressed and they must be accepted by all

the nations participating in the system. And acceptance of rules must not be simply a matter of governments' signatures: it must have behavioral meaning in the sense that observance of any set of international monetary rules will at times constrain, and explicitly constrain, individual national policies.

Libraries have been written on the general question, in economic and monetary affairs, of rules versus discretion; and the question of the desirability of an international monetary system is obviously only an aspect of the broader argument. However, in discussing the desirability of rules governing behavior *between* nations, there arises in a much sharper form than in the context of purely domestic policymaking, questions of what is possible. Since there is no equivalent in international affairs of a government or central bank with legal powers of enforcement, before we ask whether or not a particular system is desirable, we have to ask whether it will work, whether circumstances are such, or can be made to be such, that all participating nations are genuinely prepared to accept the rules, even when they imply unwelcome policy consequences.

Twenty-five years is a long time and it is not easy to assess what will become possible, practicable, or desirable over that period. A good way to start may be to look backward, to remind ourselves what things were like in 1963; how much has changed since then; and how easy or difficult it would have been to envisage the world of 1988 at that time.

Looking back, we can see 1963 as the heyday, or perhaps the late summer, of the Bretton Woods system. It had been five years since the major Western economies had moved to dollar convertibility, thus making the system fully operable. Postwar reconstruction had been long completed and trade liberalization carried to almost undreamt-of lengths—with more to come. A regime of stable exchange rates had accompanied a period of nearly stable prices, though they were beginning to creep up, and unprecedented growth in what was coming to be called the OECD (Organization for Economic Cooperation and Development) world—though it is interesting to remember that Japan did not formally join OECD until the following year.

Alongside liberalization of trade and convertibility on current account went a degree of restriction on capital transactions that is difficult to remember now. It was not merely that exchange controls were widespread and severe in most European countries and Japan. It was in 1963 that the United States itself imposed the first of a series of measures aimed at limiting capital outflows, in the form of the interest equalization tax, to be followed a couple of years later by the voluntary credit restraint program. Such measures were, of course, fully in line with the Bretton Woods system, whose founding fathers, reacting against the violence of capital flows and exchange rate fluctuations in the period between the wars, had specifically allowed for restrictions on capital movements where these could be argued to assist in the maintenance of exchange rate stability and appropriate domestic economic policies.

A few other facts may remind us of the difference between 1963 and today. Then, the gross national product (GNP) of the United States was ten times that of Japan and six times that of the Federal Republic of Germany. Today, the U.S. GNP is less than twice that of Japan, only four times that of Germany—and, in fact, barely larger than that of the European Community (EC) as a whole. In 1963 U.S. imports amounted to 4 percent of GNP, today they are over 11 percent. In 1963 the Eurocurrency markets were virtually nonexistent. International banking meant broadly correspondent banking and trade finance; and the phrase “multinational corporation” was only just coming into general use. Gold was \$35 an ounce and oil \$1 a barrel. De Gaulle vetoed the U.K. entry into the EC. Friedman and Schwartz published their *Monetary History of the United States, 1867–1960*. Finally, in this short and arbitrary list, a computer with the power of the human brain would then have had to be about as large as the Albert Hall in London; today, as large as a London taxi.

By 1963, cracks were beginning to appear in the Bretton Woods system. There was concern that exchange rates were turning out to be too rigid. There was concern about whether there was enough international liquidity—which then (we must remember) effectively meant official reserves, composed of gold, dollars, and sterling—or whether an appropriate rate of growth of liquidity could be relied upon. The IMF instituted two studies on this subject in 1963. And there were generalized, contradictory concerns about the role of reserve currencies in the system: whether they constituted an “exorbitant privilege” in de Gaulle’s famous phrase, or rather, a heavy burden. Much effort was expended during the 1960s—especially here in Basle—trying to shore up the overextended position of sterling, mainly because it was seen as the first line of defense for the dollar, whose ultimate convertibility into gold was beginning to be questioned. Gold itself was seen by both its supporters and detractors as having an almost magical power. The fundamental question whether the United States would in any circumstances abide by its responsibility under the Bretton Woods system and adjust its own exchange rate by raising the price of gold was finally answered in the negative in August 1971. In the meantime, this action was urged by those who felt it would humble the United States and restore discipline; and opposed by those who thought it would be abandoning rational thought, embracing dangerously deflationary fetishism, and helping Russia and South Africa. In my view it was an action necessary to maintain the functioning of the Bretton Woods system, entirely appropriate, and would have prolonged the predominantly beneficent hegemony of the United States many years more. But that is by the way.

What do these brief reminders of the state of international monetary affairs and of the policy debates of twenty-five years ago suggest to help us look twenty-five years forward?

First of all, the debates reek of mothballs. Overrigidity of exchange rates and dollar convertibility into gold do not much concern us these days. Will our own present concerns, which seem so fundamental, prove more enduring?

Secondly, there is the striking decline in the absolutely overwhelming economic and financial predominance of the United States. If one considers the EC as a single unit—as for some, but still sadly few, purposes one can—the change of the United States from a position of superdominance to simply one of *primus inter pares* is even more striking. This may provoke some even longer-term and more general reflections.

If we look at the position before the First World War when the United Kingdom was overwhelmingly dominant and played the role, through sterling, of the world's banker; and if we compare this with the role of the United States and the dollar in the post-Second World War period, we may be led to the view that such a situation can be a recipe for something of a golden age. The nature of whatever formalized system prevails may not be so relevant. On the other hand, when the overall predominance is challenged by the growth in power in other countries, orderly international relations are put under strain. The extreme tensions, volatility, and autarky of the inter-war period was surely at least in part a reflection of the fact that the United Kingdom was no longer strong enough to sustain a central role, while the United States was not yet able or willing to take over international responsibility. Similarly, the breakup of Bretton Woods reflected, among other things, a move from something analogous to monopoly power to something analogous to oligopoly. This pluralizing of centers of power has, of course, been intensified by the striking growth of nongovernment institutions—multinational companies, giant international banks—whose power cuts across national borders and into individual sovereign authority.

Our third and most sobering lesson looking back twenty-five years is the magnitude of the role played in changing the nature of international monetary affairs by technological developments which were virtually unpredictable in 1963: the explosion in information technology with its coruscation of video screens all over the planet. Through this revolution we have reached nothing less than a democratization of the financial markets, facilitating a gigantic expansion in instantaneous capital movements of all kinds and spelling in due course the end of serious exchange controls in all major countries.

Armed with these reflections we may look briefly at the more than fifteen years of floating exchange rates which we have now experienced. We can perhaps divide this into three periods.

The first, up to 1979, might be styled "optimism confounded." Many people believed that removing the exchange rate constraint would, in a phrase much used at the time, allow countries to "make their own mistakes" without passing the consequences on to others; while the "benign specula-



tor" (another 1970s creation) would, once the initial imbalances were removed, see that exchange rates were in practice fairly stable. Other people (including a number of governments) went further, appearing to believe that the abolition of the exchange rate constraint involved the virtual suspension of the laws of economics, allowing policymakers to do as they wished. As the great Henry Wallich remarked at the time, "some people thought floating rates could cure cancer." In fact, as we know, exchange rate volatility increased rather than decreased as the years went by; and there was an unprecedented and highly dangerous acceleration in inflation throughout the world.

This led to the second phase, from 1979 to 1985, which we may style "virtue insufficient." The major nations all decided to make the attack on inflation their overriding objective and to achieve this primarily by reliance on a new (or newly rediscovered) domestic constraint: adherence to strict rules on monetary expansion. A group of EC countries simultaneously embarked on a new role for the exchange rate, to which we will return. But many people in the United States, the United Kingdom, Japan, and elsewhere intensified rather than modified their views that the exchange rate should have no place in official policymaking. The prevailing view was that if all countries pursued the same virtuous aims, the overall world result would take care of itself. It did not work out like that.

A substantial degree of success was achieved in most countries in bringing inflation down to tolerable or nearly tolerable levels. But there were some very unpleasant side effects. Differing policy mixes have meant the need for differing degrees of severity in the use of monetary policy. Adherence to monetary rules has given a dominant position to interest rates, whose most potent effect has been on international capital flows and hence exchange rates. Countries have not got what one might style the exchange rates they deserved. Specifically, powerful (and broadly successful) anti-inflationary monetary policy in the United States, against a background of an expansionary fiscal policy, led to a ludicrous overvaluation of the dollar and an external deficit that dwarfs all previous international monetary imbalances and carries with it grave dangers to world trade and growth.

These developments led to the third—and still continuing—phase of floating exchange rates, which we might style "groping for order again." Starting with the Plaza Accord, most—though still not all—policymakers now believe that exchange rates cannot be left entirely to look after themselves. The authorities of the Group of Seven countries jointly decided first that they wanted the dollar a lot lower; and later that it had reached about the right level for elimination of international imbalances and should be stabilized. And, indeed, the dollar did fall from its vertiginous height and then has remained fairly stable, partly thanks to central bank intervention on a scale that would have been unthinkable at any previous point since the beginning of the 1970s.

There has, however, been a group of countries which throughout both the second and third phases of the world floating regime has successfully operated a regime of fixed but adjustable exchange rates very much in the spirit of Bretton Woods. It is surely impossible to deny the success that the exchange rate mechanism of the European Monetary System (EMS) has achieved. Inflation has been brought down just as effectively as in countries outside it—in some cases in the face of political and economic circumstances which made that success look unlikely or extremely difficult. Long periods of exchange rate stability over the predominant trading area for the countries concerned have been achieved; and the adjustments that have been necessary from time to time do not appear to have been delayed for unreasonably long periods.

It is interesting, however, both in relation to the previous worldwide fixed but adjustable rate regime, and in relation to any forecasts for the next twenty-five years, to note some features of the EMS. First, a number of member countries have retained some degree of exchange control—though this has been altogether less severe or pervasive than under Bretton Woods. Secondly, though again to a lesser extent than under previous regimes of stable exchange rates, the system has functioned round a dominant country and exchange rate—the Federal Republic of Germany and the deutsche mark; and the German record on price stability has been one of the very best in the world. Thirdly, however, and this distinguishes EMS very sharply from Bretton Woods, the system is not based on an external asset. The ECU plays a number of important roles, but it does not have a unique exchange rate with the banker to the system as gold did (or was supposed to) under Bretton Woods. This means, of course, that the exchange rate relationships in the system are overdetermined. No one country, or group of countries, can determine their exchange rates to any of the others unilaterally. All must be involved simultaneously. Although computers make the technical implementation of the necessary iterations child's play, the political difficulties can be considerable and the greater the number of countries the greater the problems.

In sum, the working and disciplines of the EMS system are essentially collaborative. The EMS provides much food for thought about possible future world monetary arrangements but we must remember that it has not yet been tested in conditions of totally free capital movements and with more than one dominant country.

We come now, you may think not before time, to the next twenty-five years. Let us begin by looking at how the external factors, those not under the policymakers' control, may evolve. Here I imagine my expectations will be similar to those of many people and thus may not be controversial. Unfortunately, even if this is so, it does not make it more likely that the predictions are correct.

First, the development and dispersion of economic wealth and power. It is difficult to envisage that, even over so long a period as twenty-five years, matters will change enough to produce once more one single dominant economy. That phenomenon has gone for good. What seems likely is that the United States and Japan will retain their joint pre-eminence, with the relative superiority of the United States perhaps declining further. Both powers may become somewhat more formally than is now the case the center of loose economic and financial blocs. Certainly one can see Japan's links with the advancing countries of Asia strengthening, while on the North American continent Canada, surely, and Mexico probably, will draw closer to their larger neighbor.

In South America I expect that we shall see developments that make our present preoccupations seem pleasantly out of date. One way or another, I imagine that over twenty-five years the large Latin American countries will surmount their external debt problems and become—especially if they themselves are able to forge intracontinental links, important players on the intercontinental scene—probably fairly closely linked with the United States and the dollar.

For Europe, there will clearly be more economic integration. The question is how far it will go. It is perhaps not too bold to suggest that at some point in the next twenty-five years the United Kingdom will decide that the right time has come to join the EMS; and if “1992” does not occur in 1992—as it probably will not—it will surely have occurred by the year 2013. But for our present purposes the key question is whether a true central bank and a true common currency will have emerged. Here, I am on the side of the skeptics. Certainly in the past one would never have lost money betting against predictions that nations, in Europe or anywhere else, would cede sovereignty; and I should regard a genuine EC central bank issuing a genuine common currency as representing a very fundamental political change indeed.

It is certainly likely that the EC nations will move a long way towards greater collaboration in their external economic and financial policies; and that they will also increasingly harmonize their domestic policies. But if one looks at what has already happened in this area since 1963 the changes are surely of degree rather than kind: they have certainly been slower than the visionaries expected. As communications improve, many more people travel, English is increasingly used as a *lingua franca*, it is a commonly observed paradox that local pressure for national differentiation, especially on grounds of language, appear to grow stronger. The cases of Belgium and Wales come to mind. But I am skeptical about true monetary union on a deeper ground than this: the difficulty of *utterly* persuading the markets that a currency link is permanent and irreversible. Consider the case of the British and Irish pounds which had been established as virtually a common currency for many decades but which broke apart under the force of

circumstances. There is, it seems to me, no lock binding two currencies together to which each finance minister does not hold the key and which he may ultimately not be prepared to use.

As I shall indicate below, developments over the next quarter century are likely greatly to reduce the effective degree of sovereignty exercised by individual governments, even the largest. But this does not imply that the voluntary yielding of that sovereignty to a larger group of countries is going to become easier or more likely. Rather, the reverse.

I see it as very probable that the non-EC members of Western Europe will link themselves even more closely to the EC than they do today in terms of trade and broad exchange rate movements. Thus, Europe will represent a very large bloc and be a relatively more important player than it is today; but still not, in my view, an ultimate individual, indissoluble, monetary unit.

One development one might well have overpredicted in 1963 is the emergence of the communist countries as significant players on the field of free market movements in goods, services, and capital. Despite their disappointing progress in the past, however, I should expect that certainly China, very probably the Eastern European countries and possibly even Russia, will in the next quarter century increase enough in economic strength and political self-confidence to link themselves significantly, if not totally, into the world of convertible currencies.

Without going further into possible developments in India and the rest of Asia or the rest of the world, the picture becomes fairly clear: a rather large number of substantial countries of economic blocs. Moreover, a very important development if it occurs (and subject to a possible qualification to be mentioned), I should expect that the ratio of imports to GNP would rise substantially in all countries, as it has over the past twenty-five years in most of them (though not Japan).

We may turn now to the prospects for information technology. Here there seems no reason to expect that the almost exponential rate of expansion over the past twenty-five years will significantly slacken. But this implies developments that are almost literally impossible to imagine. The size of a computer with the power of a human brain will have become smaller than a human brain long before 2013.

The relative costs of hardware and software and all their combinations will continue to fall; and by the end of our period, what I have called the democratization of financial markets will be complete. Every decision maker in most parts of the world will, if he wishes, be able to plug into a world system of information, both to learn what is happening and to carry out his own operations. This will further increase the size and pervasiveness of financial flows of all kinds. Certainly, it would seem finally to rule out the possibility of effective exchange controls (already seriously reduced, as we have observed). Whether these developments will also exponentially increase the volatility of exchange rates and interest rates is more doubtful.

The recent very rapid development of all forms of financial hedges through swaps, futures, options, etc., is likely to accelerate rather than slow down and this may have some neutralizing effect.

I suggest that we shall also see a parallel impact on the world of goods and nonfinancial services, which will mean that much which is now physically transported across frontiers as trade will no longer need to do so. The development of fax machines, the use of satellites, already means for example that newspapers do not have to be flown from country to country and go through customs but can appear full grown in countries other than those in which they are initiated. This simple and now familiar example will surely be many times multiplied. As the amount of information and instructions becomes a greater and greater part of the value added in many products, the amount of physical trade as at present constituted is likely to decline relatively.

All this is heady stuff and one should properly pause to query it. The past is littered with predictions of technological revolutions which have not occurred—or occurred very much more slowly than the enthusiasts predicted. (In the 1930s many people seemed to expect that we should all fairly soon have private helicopters with pads on our roof.) Can one really extrapolate the trends of recent years in this field? Broadly, I believe one can.

We may have some bumpy periods ahead: a serious recession perhaps. And the political climate may conceivably move away from the liberalization of recent years towards restriction and protection. But it looks as if it will become increasingly difficult to make such restrictionism bite. A number of developments are likely to conspire to produce in different fields small numbers of truly global privately owned organizations—multinational industrial, commercial, and financial service groups—whose powers will be hard to negate.

What then are the implications of the world we are sketching for the possibility of an international monetary system? First, we see no super-dominant power and, therefore, no single banker to the system. Secondly, there seems no likelihood of the development of, or a return to, an ultimate or outside reserve asset. Gold will, I am sure, continue as an important store of value. The SDR and the ECU will be important numeraires; and increasingly used as vehicles for international transactions. Perhaps, as at present it seems fashionable to urge, baskets of commodities, including gold, may be used as reference indicators for policy.

But all these are minor roles, compared with the role gold clearly played before the First World War and was intended to play under Bretton Woods. A true reserve base for a system is one to which countries are prepared to link themselves in a formal and constraining way. To my mind, once countries have shown they can break such formal links without obviously disastrous consequences, there has in a sense been an eating of the apple of knowledge. One of the most poignant remarks in international monetary

history was that of the member of the 1929–31 U.K. Labour Government when the succeeding national government went off gold: "They never told us we could do that." Almost exactly forty years later the United States did it again rather than be constrained; and I cannot see how, at any time in the future, peoples and governments will be able to invest any outside asset—if not gold, then certainly not a paper currency—with sufficient decision-constraining significance to form part of an international system.

We confront therefore for the indefinite future an oligopolistic world where power is dispersed in complicated and probably unformulated ways: a few very large nations or blocs whose apparent strengths are in many ways slighter than they seem because of the corporate and information technology webs of power that run through them. In this situation how will countries behave? Will we see a steady development towards the target zones which are becoming so popular today? Perhaps. But target zones mean little without specifying the policy context in which they are supposed to operate. We saw earlier that concentration on domestic monetary policies, without regard to fiscal or other policies, actually increased the volatility of exchange rates, even when the major countries share the same ultimate goal of subduing inflation.

One suggestion is that the major powers in some sense operate a joint monetary policy based on the concept of a global rather than a series of domestic monetary supplies. This bristles with difficulties which are unlikely to go away: in particular, the problem which has become so severe in recent years of identifying a particular group of financial assets (called money) which has a discontinuous relationship with the rest of the spectrum of financial assets is likely to grow more rather than less intractable.

In practice it looks to me as if we shall have to rely on a continuous, untidy debate over the whole array of policies in the major players—especially the United States and Japan: and there will have to be an enormous increase compared with the present position in the degree to which individual players adjust their policies from those which they would ideally desire, on international grounds.

There will be a very bumpy road ahead towards this situation. Many target zone ideas will be espoused and will break down under force of circumstances. Periods of concord will alternate with periods of discord. But one may perhaps be hopeful that in the end something workable will emerge, as the sovereign powers concerned learn by continual lessons of the disadvantages to themselves of not iterating fully the consequences of individually chosen policies. The relative openness of even the largest economies and the relative powers of the large multinational corporate organizations will perhaps gradually conspire to bring the big powers increasingly into a clumsy but ever closer form of collaboration. Further down the power and size scale, other nations will hitch their wagons to one star or another.

It will, in my view, not be a system; and in many respects it will be unattractive in lacking the equality of treatment of different countries, regardless of size, that the Bretton Woods system appeared to give. But even there, equality of treatment was more apparent than real. In the future we are likely to have to see the reality of inequality more clearly. Those with long memories will recall that around the end of the last war there was a competitor to Bretton Woods as a blueprint for the postwar international monetary regime: the key-currency system put forward by John L. Williams of the Federal Reserve Bank of New York. That idea failed to win the day at that time, and probably rightly so. The United Kingdom would not have been able to carry the burden that the envisaged role for sterling would have implied for it. But, perhaps, fifty years after his time Williams's ideas may ultimately bear fruit, in a form he certainly never imagined, with the dollar and the yen as the key currencies.

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SIR JEREMY MORSE: Thank you very much, Kit, for a splendid start, and now Tommaso Padoa-Schioppa.

# **Towards a New Adjustable Peg?**

**Tommaso Padoa-Schioppa**

Mr. Chairman and distinguished guests, to address this audience on such a challenging subject as “the next twenty-five years of the international monetary system” is both a great honor and an all but impossible task, made even more demanding by the high standard set by so many illustrious predecessors.

A twenty-five-year time horizon would be unusually long for any policy-maker; it is even more so for a central banker. The first question is: what is the scope for change over such a time span?

Far-reaching changes can occur very quickly. The Bretton Woods conference lasted about three weeks; the fixed exchange rate system was wound up in one day, August 15, 1971; the European Monetary System (EMS) took about six months to set up. The first and the last of these events also had relatively short gestation periods. Other changes took longer, fifteen to twenty years: the return to currency convertibility, significant progress in liberalizing trade, more recently a new attempt by industrial countries to manage exchange rates jointly. Plans for reform sometimes have to be formulated and adopted rapidly to exploit favorable circumstances that do not last long. However, the underlying ideas and economic realities change slowly.

My remarks are not intended to formulate plans. Rather, convinced as I am that the future is hidden in the present, I shall try to identify a viable future system that could grow from seeds that are distinguishable today. Optimism is a necessary ingredient of this intellectual exercise: to get some, I shall try to look at the latter part of the twenty-five years. As to the implementation, it requires a mixture of economic logic, discernment of what is possible, determination in pursuing distant goals, and good luck.

The Bretton Woods system and the EMS are the only structured monetary systems we have known since World War II. Their duration and historical roles make it natural to refer to them, rather than to earlier systems, when reflecting on the future evolution of world monetary relationships. Because of my age and curriculum vitae, what I know about Bretton Woods (not to mention the gold standard) derives from reading, whereas the EMS is the system with which I have had a professional experience. Thus, the lessons, both practical and intellectual, that can be learned from the EMS, are probably influencing me most. In my remarks, however, references to the



EMS will often be implicit. And in the explicit one I will argue that a direct transplant of its mechanism to the international monetary system would be a risky operation.

### *The Limits of Second-Best Systems*

Ever since Kant published "Towards Perpetual Peace," the radical solution to the problems of international relations has been the creation of a "universal government." This is no less true in economic matters than in the broader political sphere, for two reasons: firstly, because economic activity cannot develop effectively without some form of government; secondly, because the boundaries of nation states no longer coincide with those of markets. Resolution of the conflict implicit in these propositions involves moving towards utopia or, in other words, towards an institution empowered to govern the economic affairs of the world.

When we lower our eyes from these utopian heights to the real world, the difficulty of designing a viable international monetary order is such that we have to have a logical framework to order our concepts. The one I consider simplest and most enlightening can be summarized as follows: a group of countries cannot simultaneously have free trade, full mobility of capital, fixed exchange rates, and autonomous macroeconomic policies. When they occur together, these four elements form an "inconsistent quartet" and any system in which they coexist is overdetermined.<sup>1</sup>

In our current non-utopian language we generally bestow the name of "system" on a set of monetary arrangements that removes or limits one, or some appropriate combination, of the four elements, without providing a fully-fledged "Kantian" solution, in the form of a supranational monetary union. However, as long as there are conflicts between national policy goals and countries retain the power to override others, such arrangements contain an inherent instability that prevents them from enduring. The special devices introduced to cope with the inconsistency are just devices. Their effectiveness tends to wane and the inconsistency inevitably reappears somewhere in the system. It is this that makes such arrangements second-best solutions.

International monetary history in the postwar period can be interpreted in terms of the periodic manifestations of the "inconsistent quartet" and the ensuing reactions and adaptations.

The economic order created at Bretton Woods and La Habana was based on free trade and fixed exchange rates; the inconsistency was reconciled by

<sup>1</sup>In his 1972 Per Jacobsson Lecture Henry Wallich noted that this incompatibility was "a fact well known to economists but never recognized in our institutional arrangements or avowed principles of national policy." See Henry C. Wallich, *The Monetary Crisis of 1971—The Lessons to Be Learned*, pp. 6–7.

allowing (even encouraging) official control of capital flows. In principle, the autonomy of national macroeconomic policies, the fourth element of the quartet, was preserved; in practice, the United States exerted a powerful influence on their formulation.

Subsequent developments saw both an unfolding of the ability of that system to promote orderly and sustained economic growth and the outbreak of its contradictions. In short, the rapid expansion of world trade and the consequent need for freer payments arrangements caused the return to currency convertibility. This, in turn, entailed the progressive abandonment of capital restrictions. At the same time, fast economic growth in Europe and Japan led to an erosion of U.S. leadership and to a weakening of the dollar. By the early 1970s the system had come full circle. The two functions Bretton Woods had reserved to the authorities, the control of exchange rates and management of international capital flows, had been handed over to the markets.<sup>2</sup> The simple approach of the 1940s to the inconsistent quartet was replaced by a more complex one in which each of the four elements was restrained in some way to make room for the others. Even the temptation to restrict trade flows was stronger after the collapse of the Bretton Woods order, and countries yielded to it on more than one occasion.

### *Exchange Rates*

The switch to floating rates appeared to be inevitable and was made irreversible by the first oil shock and the surge in other commodity prices. It was greeted with satisfaction by most academic economists and with relief by many government officials, in the belief that market determination of exchange rates would ensure external adjustment, reconcile conflicting national policies, and free them from the external constraint.<sup>3</sup>

Developments in the 1970s and 1980s have belied these hopes. Many exchange rate movements undoubtedly helped to maintain an open trading system in the face of real disturbances of unprecedented magnitude. On the whole, however, markets have failed to keep exchange rates in line with their fundamental determinants and have produced large and lasting misalign-

<sup>2</sup>The two events that marked the transition, the abandonment of the Smithsonian parities and the decision to leave the recycling of oil surpluses to the markets, were linked and almost simultaneous.

<sup>3</sup>This view was heavily influenced by the article Milton Friedman published in 1951, when the economic and political hegemony of the United States in the Western world was undisputed, capital movements were highly controlled, and the degree of commercial and financial integration of industrial countries was still small. It is worth noting that Friedman was advocating flexible exchange rates for the United States, where the ratio of imports to GNP was a tiny 5 percent, so that the domestic repercussions of exchange rate changes were unlikely to be seen as important.

ments.<sup>4</sup> Real exchange rate cycles have strained trade relations and fueled protectionism, disrupted cost and profit calculations, and have led to misallocation and waste. Instead of emerging disequilibria being met by stabilizing movements in exchange rates, there has been belated adjustment, often in disorderly markets. Economic interdependence and national policy interaction have remained strong, more as a consequence of the "real" links in the production and exchange of goods and services than as the effect of a particular exchange rate regime.

In Europe, recognition of the costs and inefficiencies of floating led to exchange rates being returned to official custody with the creation of the EMS in 1979. At the world level, the Plaza Accord (September 1985) and the Louvre Accord (February 1987) mark the return to joint official management of exchange rates. The Group of Seven understandings of December 1987 (Louvre II) represent further progress in this direction.

I would describe these arrangements as cautious and somewhat experimental steps into the long-abandoned land of the adjustable peg. This term is often badly received because it is associated with the inability to "adjust" and the stubborn "peg" that characterized the agony of the Bretton Woods system. But, what else do we have if not some kind of adjustable peg when governments take a view on the level of exchange rates or the direction in which they should move; translate this view into "reference zones" for exchange rates; defend this view through exchange market interventions coordinated as to timing, techniques, and amounts; and conduct regular joint policy reviews?

Will the major countries quickly retreat, leaving the Plaza and the Louvre as isolated examples of "ad hoc" cooperation, pauses in a long period of exchange rate neglect? It is possible. However, I regard it as more probable that these agreements will mark the beginning of a phase from which a new international monetary system could emerge, and certainly far more desirable that it should do so.

The reasons for putting exchange rates at the center of economic cooperation are strong: their definition is unambiguous; they are the principal link between countries and the main medium of interdependence; numerous policy instruments, including market intervention, interest rates, and domestic demand management, interact with them; their impact on national economies is pervasive; their misbehavior poses major threats to free trade.

A more structured adjustable peg than the pragmatic Group of Seven approach would have to develop more precise arrangements regarding the definition of the peg, the permitted range of flexibility, the degree of symmetry in both the range and the intervention rules, the publicizing of commitments, etc. These crucial questions are undoubtedly difficult. However, one may be confident that the vast literature on exchange rate

<sup>4</sup>Misalignments can result equally from excessive flexibility of exchange rates, as happened under floating, and from insufficient flexibility of exchange rates, as under Bretton Woods; however, they have been distinctively larger in the 1970s and 1980s.

regimes and the ingenuity of officials will be a sufficient source of inspiration to policymakers. Let me thus revert to other questions that, together with an exchange rate regime, will have to compose an international monetary system.

### *Capital Mobility and the Legacy of Debts*

Several factors led to capital mobility being taken up by private markets: the complementarity of real and financial transactions; the desire to avoid regulations and taxation; financial innovation and advances in communications; the belief that capital mobility and global financial markets would improve allocative efficiency; and the widening international separation between final savers and borrowers, epitomized by the oil surpluses and deficits.

In the global financial market two aspects of capital mobility have taken on special importance: currency diversification and direct investment.

First, currency diversification. The motive of many financial transactions is not to transfer capital between residents of different nations but to change the currency composition of portfolios. In addition, issues are increasingly denominated in currencies other than the national currency of issuer. Complete freedom of denomination for all borrowers and lenders (including sovereign ones) may be inevitable and—under certain conditions and with certain precautions—desirable. On the other hand, measures to offset the exchange rate consequences of “pure” currency diversification should not be censured on grounds of allocative efficiency as severely as measures regarding other capital movements or trade.

Second, and at the opposite extreme, direct investment. Through acquisitions or new plants, large international corporations increasingly spread production in different currency areas, not only to exploit more favorable conditions for production but also to avoid trade restrictions and exchange rate risks. The increasing probability of employers and employees in industry not being of the same nationality is an aspect of the blurring of economic frontiers that may have positive stabilizing consequences.

The legacy of debts is tightly interwoven with capital mobility. The evolution of the international monetary system will be marked for many years by the large debts accumulated by certain developing countries in the 1970s and early 1980s, and more recently by the United States.<sup>5</sup> Debts on

<sup>5</sup>The debts of the 1980s suggest analogies with episodes of the past. The sterling balances, akin to the U.S. debt problem, retarded the recovery of the United Kingdom after World War II and accelerated the decline of sterling as a reserve currency. German reparations and large foreign indebtedness in the 1920s, akin to the debt problem of the developing countries, anticipated the beginning of the great depression in Germany and aggravated its severity. The U.S. foreign debt of the late nineteenth century, on the other hand, cannot be likened to the debt this country is accumulating in the last part of this century. Then, foreign capital flowed from more mature economies into the United States to finance its development, adding to the country's capital stock. By contrast, most of the capital inflow of the 1980s has been used to finance public sector deficits and consumption.

this scale, which would not have been possible without open financial markets, affect the international monetary system in various ways. Being hostage to a steady inflow of foreign capital, debtor countries cannot ignore the views of international creditors. The debts are so large that they continuously threaten the world economy with a crisis of confidence and financial instability. The foreign borrowing of the United States may also hasten the decline of the dollar as the leading reserve instrument and cause periodic bouts of currency instability.

Whatever opinion we may have on the contribution of short-term capital flows to world economic welfare (and mine is rather skeptical), the free movement of capital of all maturities will be a lasting feature of international monetary relationships against a background of latent, but occasionally manifest, financial instability. We cannot, and indeed should not, expect a curbing of capital mobility to help reconcile the inconsistent quartet. What we can and should do is to prevent capital mobility and the debt legacy from being the source of shocks for the exchange rate system.

For this purpose a much more complex formula than that of 1944 will be needed. It will have to include global prudential controls on financial markets and institutions, greater freedom and safeguards for direct investment, cooperation between creditors and debtors to protect assets, and instruments to avoid the undesirable consequences of pure currency diversification.

### *Coordination or an International Currency?*

Managed exchange rates and a high degree of capital mobility lead attention back to the fourth element of the inconsistent quartet, national policy autonomy. The implications of reserve countries' monetary policies for exchange rates and international liquidity are a crucial aspect in this regard.

The key to a stable domestic monetary system is a currency managed to ensure it is abundant enough to satisfy the needs of commerce, but sufficiently scarce to retain a stable value. A system with the same guarantees for an economy made up of many sovereign nations has to satisfy two requirements, which can be labeled "unicity" and "stability." Jointly managed exchange rates, coupled with capital mobility, allow for only one monetary policy in the area; and price stability requires an institutional system with a mandate to privilege this objective when it conflicts with other goals.<sup>6</sup>

<sup>6</sup>Fixing exchange rates is not sufficient since it leaves the world price level indeterminate: in principle, stable exchange rates are consistent with any rate of inflation in the reserve currency countries. To cope with this problem, commonly referred to as the *n*th-country problem, recent proposals have ranged from McKinnon's world money supply rule, to the stabilization of world prices of traded goods or of an index of commodity prices, to a return to a gold standard. In the end, all these proposals involve subordinating national policy goals to an externally established standard or objective.

In principle, a stable anchor for monetary policies could be provided by a national currency, an international currency, or a group of national currencies. Let us briefly consider each of the three options.

A single national currency satisfies the requirement of unicity, but it is unlikely to provide lasting stability. In no system of the past was the national-international currency completely free from any exogenous discipline. The Bretton Woods system, which came closest to this extreme, has shown that this solution involves the risk of the reserve currency country misusing its power of (world) seignorage. On the other hand, seeking to limit this danger by making the currency convertible into an "outside" asset such as gold exposes the system to long-run instability à la Triffin. Unless, by chance, the stock of the outside asset grows in line with the demand for international liquidity, any commodity standard is likely to lead to arbitrary cycles of inflation and deflation. Moreover, if the demand for international liquidity is accommodated by letting fiat money increase in relation to the gold base, convertibility will eventually break down.

The international community has periodically come to the threshold of the second solution, an internationally created currency, which undoubtedly has great intellectual appeal and comes closest to utopia. Keynes proposed the Bancor. The SDR, the asset settlement scheme, and the plan for a substitution account are all attempts to move in this direction. For the EMS it may be possible to achieve such a solution at the regional level, and this could give a decisive impulse to consideration of the same solution for the world. The difficulties to be overcome, however, are evident. First, a definitive transfer of national sovereignty would have to be made, to an institution endowed with powers equivalent to those of a national central bank. Money cannot be managed by multilateral negotiation. Second, international financial markets make liquidity available on such a scale that the very notion of controlling the international adjustment process through the supply of an international currency could be undermined.

This means that the multicurrency reserve system is likely to remain in place and evolve for several years. The external debt of the United States and the surpluses of the Federal Republic of Germany and Japan will reduce the disparities between the roles of the three key currencies and continue to promote the internationalization of the deutsche mark and yen capital markets. If the EMS continues to evolve towards a monetary union, a redefined ECU may develop into a fully-fledged reserve currency for use both inside and outside Europe. The multicurrency character of the world economy may spread from the financial to the commodity markets.

On neither the "stability" nor the "unicity" front are the systemic features of a multicurrency reserve system fully understood as yet. As to stability, it can be argued that a multicurrency reserve system would have certain advantages over one based on a single national currency, because competition between currencies could restrain the authorities involved from deviat-

ing from a virtuous course.<sup>7</sup> However, it is questionable whether this disciplinary mechanism is sufficient to achieve satisfactory price stability. As to the unicity of policy, a multicurrency reserve system is obviously weak, as shown by the experience of recent years: huge external imbalances have developed in the reserve currency countries and foreign assets and liabilities are accumulating at unsustainable rates. Stable policies and a common commitment to coordination by the reserve currency countries are indispensable if there is to be a collective nominal anchor for the world price level. As I shall argue, this requires a strong institutional setting.

### *Can the EMS Be Exported to the World?*

Any adjustable peg has to reconcile two somewhat conflicting requirements. It must foster trade and an efficient allocation of resources by minimizing frictions and protectionist pressures; it must also optimize the interactions between exchange rates and macropolicies to achieve a satisfactory mix of price stability and employment. The first requirement calls for the fixity of a rule, the second for the flexibility of discretion.

On this score the EMS has been remarkably successful in a period in which disinflation was the top policy priority. Normally exchange rates are virtually fixed; when economic fundamentals call for a realignment of central rates, the authorities have to exercise their judgment and arrive at mutually acceptable changes. The rule operates during the week, discretion over weekends.

The fundamental lesson of the EMS is that an adjustable peg can work; that, properly managed, a satisfactory balance between “fixity” and “adjustability” can be achieved, while avoiding the rigidities that led to the breakdown of the Bretton Woods system. “Proper management” has several implications: that realignments be the result of truly collective decisions; that changes in central rates be accompanied by domestic policy corrections; that collective benefits be seen to outweigh the sum of individual advantages; and that cooperation become usual practice.

Does this positive experience make outright adoption of a “world EMS” recommendable? I would suggest two reasons for caution.

First, the success of the EMS owes much to factors that are peculiar to Europe. The participating economies are more open, more closely integrated and more homogeneous than the United States-Europe-Japan trio. Moreover, the institutional edifice that hosts and supports the system is far richer and involves much wider interests: it comprises a large body of legislation directly applicable in member states, an elected Parliament that involves political parties in the “European cause,” and a host of Committees

<sup>7</sup>It is in this sense that Otmar Emminger used to predict a period of “competitive revaluations” of reserve currencies.

and Councils where officials constantly meet and harmonize their views. As a consequence, the failure of a major "project" like the EMS would entail such economic and political costs that on some critical occasions countries have preferred to change their domestic policies rather than drop out of the system. Without this edifice, the ability of the system to enforce coordination would be insufficient. Finally, the arrangements for monitoring are highly developed and ensure not only a regular exchange of information but also a smooth shift from ordinary to crisis (realignment) management.

Second, the EMS itself is evolving in response both to the systemic instability of the "inconsistent quartet" and to the changing real conditions of participating economies. Broadly speaking, the disinflationary phase of the EMS was successfully completed around 1986, with the help of the rising dollar and the (remaining) foreign exchange controls still in force in France and Italy. During that phase it was natural for the higher-inflation countries to accept some appreciation of their real exchange rates and a deterioration in their trade balances as a fair price for disinflation.

The system is now confronted with two new challenges: huge payments imbalances that are not due to inflation differentials,<sup>8</sup> and the now imminent (it could be literally tomorrow) liberalization of all short-term capital movements. The difficulties inherent in these challenges are aggravated by the policy dilemma posed by their having come at the same time. Discouragement of speculative capital movements would require eradicating expectations of realignments, but widening payments imbalances within the area may call for exchange rate adjustments at some stage.

Thus, before becoming exportable, the EMS will have to pass these challenges, which are more akin to those a "world" EMS would have to face than to those that were successfully overcome in the past.

### *Rules, Institutions, and Leadership*

Let me now turn to coordination and discretion at the world level.

For exchange rates, only the two extreme solutions of fixity and floating entail a simple and unambiguous rule; any intermediate regime involves a combination of rules and discretion, which is, however, difficult to attain. It involves achieving the right balance between monetary discipline (stabilization) and trade integration (efficient resource allocation).

As to aggregate demand policy, no rule can be expected to achieve the coordination that is necessary to satisfy the need for consistency. Setting priorities, weighting the relative importance of different variables, making choices, and deciding who should act are problems that only judgment, and

<sup>8</sup>From 1985 to 1987 the EMS countries accumulated a current external surplus of ECU 109 billion, largely due to the ECU 100 billion surplus of the Federal Republic of Germany, of which about one half derived from trade with the partners in the exchange rate mechanism.



compromise, can deal with—at the international no less than at the national level. A common view of the working of the world economy and of the interactions between national economies, embodied perhaps in a set of indicators, can help in the exercise of discretion. But a common model is something totally different from a policy rule. The complexity of economic interactions between countries could not be sorted out with a rule book.

Who, then, is to exercise discretion? Since there is no prospect of a single leader country emerging, the obvious answer is that it should be exercised by the international community in a cooperative way.

In our industrial democracies, however, it would be unrealistic to expect cooperation to prevail spontaneously whenever needed: countries' immediate interests and objectives are conflicting; national political cycles differ in their timing and policy implications; and negotiations would take too long. It is no accident that countries do not rely on this method in their domestic affairs: anarchy has never succeeded in managing relations within a large group. Thus, the only option to be considered requires an international institution to play a stronger role.

Since Keynes, the idea of a world central bank as an institutional solution to the problem of coordination has attracted such men of vision and experience as Robert McNamara and William McChesney Martin (who presented it in an earlier lecture in this forum); more recently, Richard Cooper. A period of twenty-five years may be long enough to offer room, and hope, for this "Kantian" solution. However, the need for a stronger international institution is urgent. In both an intermediate and a distant solution, this institution can only be the International Monetary Fund, an IMF in which the monetary mission has regained a central position. To this end, the IMF will have to be clearly entrusted by the international community with the task of promoting monetary stability in a world of managed exchange rates, open trade, and capital mobility. Its role in analyzing economic conditions and policies and in preparing independent assessments will have to be enhanced. It will have to have more authority to organize and exert effective pressure for cooperative decisions when policy conflicts arise. In a reshaped IMF, the role and functions of its operational instrument—financial assistance—may have to be reconsidered and adapted to the pursuit of the objective of overall stability in financial and exchange markets.

A stronger institutional setting is the only way to move beyond the endless restarting of the cooperation game every time that new administrations, ministers, and officials come into office. Quoting Amiel, Jean Monnet used to say: "*l'expérience de chaque homme se recommence. Seules les institutions deviennent plus sages.*"

A related problem is the institutional framework for dealing with issues involving more than one policy area, such as trade and exchange rates. Such issues are increasing in number and importance. The European Community

(EC) greatly benefits from the existence of such an all-embracing framework. For the world, the present configuration of specialized international institutions leaves too much room for bilateral arrangements and multilateral discussions that are not guided by the work and the authority of an organization that "speaks for the world."

### *Participants, Regional Arrangements, and Free Riders*

Under Bretton Woods the same rules and obligations applied to all countries, apart from the United States. The central position of the latter was due as much to the relative size of its economy as to its political leadership in the postwar economic recovery. The United States imparted energy to the rest of the system by supplying the reserve currency.

The more complex world of today resembles a galaxy rather than a solar system: 151 countries are members of the IMF, compared with 30 in 1945; those that have an influence on the world economy, either individually or in organized groups, are numerous and heterogeneous, ranging from the EC to the Organization of Petroleum Exporting Countries. Since a polycentric and fragmented reality is likely to remain in the future, the international institutions will have to adapt to it. Three main aspects of this adaptation are regional arrangements and country groupings, relationships between reserve centers, and the treatment of "free riding."

It is fair to say that the EC and the EMS represent the most conspicuous example of a regional arrangement (the Association of South East Asian Nations and the European Free Trade Association are others), and also the only multicountry system that explicitly aims at a "Kantian" solution and approaches it in several respects. In my view, regional monetary arrangements should be encouraged as a necessary component of a new international monetary order. The organizational reason is that the number of sovereign countries in the world economy is now so large that intermediate levels of aggregation have become indispensable. The economic reason is that certain regions of the world are integrated to the point of constituting a potential currency area. In these regions North-South trade relations are intense and many of the currencies of the "Southern countries" are already pegged to the key reserve currencies or to a basket of them. It is conceivable that three major monetary areas will emerge in the market economy world, based on three leading reserve currencies—the U.S. dollar, the deutsche mark, and the Japanese yen. Two of these areas will reflect the growing economic coalescence around the United States and the EC, respectively, of Latin America and Africa. By contrast, Asia's future economic configuration is far less clear. Despite their close industrial ties with Japan, the newly industrializing economies still base exchange rate policy on the dollar. More importantly, the economic awakening of the two giants of the region, India and China, has only just started. It is worth noting, however, that China's

recent opening of its frontiers to the market economies has been followed by a boom in business with Japan, which accounts for about 60 percent of all Chinese merchandise trade with the Western industrial countries.

As to the relationships between the key reserve currencies, which are currently regulated within the Group of Five, the Group of Seven, and the Group of Ten, it seems clear that they should be increasingly brought into line with today's tripolar reality of the industrial world. In particular, any attempt to strengthen the international monetary system that did not recognize the EMS as one of the three poles in the world economy would cause such trade and monetary (and perhaps political) tensions that it would have little chance of success. Moreover, the signs of interest in a "convertible ruble" suggest that the world organization of the international monetary system could also include a fourth area comprising the centrally planned economies, most of which are already organized in the COMECON.

Finally, the problem of "free riders." Some countries yield to the temptation of enjoying the benefits of an open system without incurring the costs.<sup>9</sup> For the proper functioning of the international monetary system such behavior should be discouraged, if necessary by adopting sanctions in areas in which they would be effective. This suggests that some institutionalized linking of trade, financial, and monetary matters will be necessary, and that the central institutions would have to be able to enforce international law. On both these scores, the EC is ahead of the rest of the world.

### *What Will Promote Change?*

In the past a number of factors have led to change, for better or worse, in international monetary relations: oil shocks, uncoordinated macropolicies in the major countries, increasing capital mobility, the re-emergence of a political will to strengthen the EC, the acquisition of multinational status by both industrial and financial companies, and developing country and U.S. debt.

Looking ahead, one can ask what forces, apart from those stemming from the inconsistent quartet, could foster positive change in the international monetary system. The two I can see are: developments in trade arrangements and the international business community.

The Uruguay Round, launched in 1986 and to be concluded by 1990, is a major attempt by the international community to halt the erosion of the

<sup>9</sup>Some are gaining from the (relatively) free environment of international trade, while keeping their markets closed to foreign goods on the questionable grounds of their low level of development (in fact their products compete successfully in world markets). Others exploit the benefits of open financial markets, by promoting "safe haven" financial centers. Finally, partial participation in existing regional arrangements gives an opportunity to gain from the economic integration which those arrangements promote, while not paying the cost in terms of autonomy of domestic policies.

multilateral trade system, to respond to the protectionist pressures generated by huge and persistent payments imbalances, and to strengthen the rules and enforcement powers of the General Agreement on Tariffs and Trade (GATT). The agenda of the negotiations recognizes the complementary nature of goods and services in trade and the links between trade and monetary-exchange rate matters. As Sylvia Ostry has argued so cogently in her Per Jacobsson lecture last year, freer trade will generate pressure for more effective exchange rate and macroeconomic policy cooperation. It should not be forgotten that a powerful impulse to the creation of the EMS came from the progressive deterioration of intra-EC trade relations and the common agricultural policy (CAP), a reality that is not always in the field of vision of monetary authorities, but that is of keen interest to political leaders.

The second force is the international business community. Awareness of the costs of the uncertainty resulting from large swings in real and nominal exchange rates has made the business community increasingly interested in exchange rate stability. Attempts to reduce these costs by relocating production in foreign countries are bound to lead to inefficient resource allocation since they are not in response to factor price changes caused by lasting differences in factor productivity. Similarly, in the financial sphere, market participants are concerned lest excessive "turbulence" in the monetary-financial field should lead to the reintroduction of capital controls and a retreat from the present high level of financial integration. The business community used to advocate protectionism, but several decades of increasing trade integration have created a powerful interest in improving, rather than manipulating, an open trade system.

### *Pulling the Threads Together*

Bretton Woods has long since completed its parabola and for the very reasons that caused its demise it would be absurd to try to resuscitate it *tel quel*. Its central element, however, an adjustable exchange rate peg, is precisely the one that is now lacking and that one would want to see reintroduced. The EMS has successfully applied such a regime, but we know that it is evolving and that in many ways it is peculiar to Europe: it could not be easily transplanted to the world.

Thus, whatever system emerges in the coming years, it will be "new." It will have more than 151 members, involve more than one reserve currency, have to cope with large and powerful markets and with near-complete international mobility of capital. It will not be guided by the economic and monetary hegemony of any one country, and it will have to cope with the indeterminacy of an oligopoly. Its distinctive feature will be emphasis on discretion in the rules-discretion mix of international policymaking, coupled with the necessary complement of stronger institutional arrangements.

An IMF recast in a new mold would be the keystone of this new system. Its monetary function would be exalted and directed primarily at ensuring the proper functioning of an adjustable peg between the (probably three) major reserve currencies. To this end, it would have operational instruments and a strong mandate from the international community to actively press for the adoption of appropriate policies. Its revived systemic role would prevail over its traditional bilateral one of monitoring and, when needed, supporting and conditioning the policies of its large array of member countries. The new IMF should extend its scope to regional arrangements, that would be fully recognized and promoted. It would further encourage the growing involvement of centrally planned economies in international trade and finance. It would have the instruments to counter "free riding" effectively if its activity was institutionally coordinated with that of the GATT and other international organizations. Such an IMF would still be far from a world central bank, but it would represent a significant advance in that direction.

In these reflections I have deliberately avoided two extreme cases: one is the miracle of a "Kantian" solution coming into being, the other is a disintegration of the fragile fabric of trade and monetary relationships, following the outbreak of unresolved policy conflicts. To design a positive, though non-utopian, evolution I have focused on the good seeds and neglected the weeds that could throttle their growth. But these weeds are very vigorous, because they operate for the preservation of a world in which sovereign nations do not accept a permanent subordination of their policy decisions to the maintenance of the international monetary order. And the new cooperation that has been developed in the Group of Seven, although positive in many respects, has not yet come to grips with the inconsistent quartet.

For some, the missing factor in establishing a new monetary order is political will; for others, it is the intellectual capacity to design technical solutions. Personally, I do not think that the crucial difficulties are of a technical nature, and yet I believe that an intellectual contribution is crucial. It is in the realm of mental attitudes that the major difficulties lie. Analysis may suggest directions and goals that those with responsibility for policy judge not to be feasible. However, it is from this tension between analysis and judgment that good workable solutions generally spring.

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SIR JEREMY MORSE: Thank you very much, Tommaso. We can already see agreements and disagreements between our speakers. Now to finish the opening presentations, Fred Bergsten.

# The Case for Target Zones

## C. Fred Bergsten

As a guide to looking forward to the monetary system of the next twenty-five years, I have first tried to look back twenty-five years or more. In doing so, I have reached conclusions that are diametrically opposite those reached by Kit McMahon, that no orderly system is possible. Indeed, I will register several sharp disagreements with the two previous speakers.

During the first twenty-five years of postwar monetary history, the world operated an adjustable peg version of a fixed rate system—the Bretton Woods regime. But that system began to erode in the early 1960s, and twenty-five or thirty years ago there were already calls for sweeping reform. It soon became clear that Bretton Woods was unable to facilitate the kind of exchange rate changes and other adjustments that were necessary to achieve a stable international economy. The system collapsed at the outset of the early 1970s when the dollar became overvalued by 20 percent, protectionist pressures arose as a result, and the international regime could not cope. So there is a clear record of failure of that version of fixed exchange rates.

For the next twelve and a half years, from March 1973 until September 1985, we had a system (or nonsystem) of unmanaged flexibility of exchange rates. It is now clear that this system has also failed. It permitted the dollar to become overvalued by 40 to 50 percent, more than twice the misalignment that brought about the collapse of Bretton Woods. It failed to keep trade open; protectionism has been growing, and the world trading system is threatened. It failed to have any meaningful impact on national economic policies and therefore failed to achieve the most rudimentary objective of any international economic system.

The authorities have therefore been groping for new monetary arrangements for almost three years. At the Plaza in September 1985, they stated explicitly that the old system had failed. At the Tokyo Summit in May 1986, they began the indicators exercise as one track toward monetary reform. At the Louvre, in February 1987, they installed a system of reference ranges. The world's monetary authorities are proceeding with a two-track program, based on reference ranges and indicators, in an effort to find a new regime.<sup>1</sup>

We are thus in a transition to a completely new monetary system, as in the late 1960s and early 1970s. The process is evolutionary, and I would guess

<sup>1</sup>See Yoichi Funabashi, *Managing the Dollar: From the Plaza to the Louvre* (Washington: Institute for International Economics, 1988).

that we are witnessing a true Hegelian synthesis. We learned that the Bretton Woods version of fixed exchange rates was too rigid and would not work and, unlike Dr. Padoa-Schioppa, I therefore do not think we will go back to an adjustable peg system on a global basis. But we have now learned that unmanaged flexibility also failed because it is so unstable and because it produces such massive and costly misalignments. We thus need to work, over the next ten to twenty-five years, toward a system that combines the best features of both previous regimes and avoids the worst of each—the excessive instability of flexible rates, the excessive rigidity of Bretton Woods. We need to come to an intermediate solution that will provide a more stable and effective basis for the world economy.

It may be that, over time, we will move to unalterably fixed rates or a world central bank. But I think that is more than twenty-five years down the road, so is beyond even the horizon of today's discussion.

Stimulated by Kit McMahon, I would also say that I do not see a world of dollar and yen blocs of the type he discussed. Indeed, the dollar area is shrinking as the relative world role of the dollar declines. The world role of the yen is rising, but there will not be a yen bloc because no country wants to join a yen bloc. Indeed, the *only* monetary bloc (and the only trade bloc) is Europe, and I therefore reach an opposite conclusion to that of Kit McMahon. The issue is not whether this European bloc will dominate the world but whether Europe, focusing now on the European Monetary System (EMS) to a more extensive degree, will lose interest in the global system and drop out of the major role that it must play for the world system to work effectively.

But my main point is that we are headed toward an intermediate system, which is a wholly desirable outcome. It is interesting to recall that, when Bretton Woods broke down and the world went to flexible rates, there was a great deal of interest and attention in intermediate solutions. We then called them wider bands or crawling pegs.<sup>2</sup> If you put those two together, you have a close approximation to what we now call (crawling) target zones. My own view is that, among the several intermediate possibilities, the most promising and most feasible is target zones. They would represent a natural evolution from the current two-tier reform effort, particularly the reference ranges implanted since the Louvre. Moving to a systematic and effective system of target zones, which could last over a period of ten to twenty years, will require four or five basic changes from the way in which the reference range system is now being operated.

First, it will of course be critical for the officials to agree to a set of exchange rate relationships that will achieve and maintain equilibrium in national current account positions with economies in internal balance,

<sup>2</sup> A number of the leading proposals were collected in George N. Halm, ed., *Approaches to Greater Flexibility of Exchange Rates: The Bürgenstock Papers* (Princeton, New Jersey: Princeton University Press, 1970).

meaning the fastest possible economic growth without igniting new inflation. That sounds trivial, at least in principle, until we recall the method for setting the current reference ranges is to determine that they should remain wherever they are on the day that the Group of Seven meets. That is a rather quixotic and whimsical basis for trying to stabilize exchange rates. One might be lucky and hit rates on a given day that did generate current account equilibrium. We know that the Louvre effort to do so was decidedly premature, however, and that the two or three rebasings since that time have also proven unsustainable.

So it is essential that governments explicitly take a view on two key variables—the current account objectives for their countries, which they have not yet been able to do under the indicators exercise, and what exchange rates would achieve such current account outcomes. In an effort to do so on an internationally consistent basis, a group of 33 economists from all the major countries met at the Institute for International Economics late last year and suggested a set of sustainable current account objectives for all the major countries.<sup>3</sup> Such a task is obviously much easier for private economists than for officials. But our three Japanese participants were a former foreign minister, a former minister of the Economic Planning Agency, and a current leading official of the Economic Planning Agency—who agreed that Japan had to accept a cut of \$70–100 billion in its trade balance to achieve a workable and sustainable international payments pattern.

We know that it is politically very difficult for governments to agree on exchange rates that differ from where rates are in the market on the day they are meeting, which suggests to me that it is not yet time to put in place a target zone system. We know that the huge current imbalances are not yet on their way to sufficient resolution. There is no respectable model in the world that, on current exchange rates and policies, shows the U.S. external deficit falling below \$100 billion. That is obviously not sustainable. The key to the adjustment of those current imbalances, of course, will be the decisions of the new administration and new Congress in the United States in finally getting our budget under control. If they do so, the current account balances will be on their way to resolution.

At that point, the U.S. Government would be in a far better position to negotiate for serious reform in the monetary system and we would have a basis for moving forward. The task now is to negotiate the structure of the new system, while simultaneously trying to adjust the remaining imbalances. The new system could then be installed on the basis of exchange rates that show promise of maintaining equilibrium at that later point.<sup>4</sup>

<sup>3</sup>*Resolving the Global Economic Crisis: After Wall Street, A Statement by Thirty-three Economists from Thirteen Countries*, Special Report 6 (Washington: Institute for International Economics, December 1987).

<sup>4</sup>For a comprehensive analysis see C. Fred Bergsten, *America in the World Economy: A Strategy for the 1990s* (Washington: Institute for International Economics, 1988).



The second key change from current procedures is to have arrangements in place that will maintain exchange rates at the agreed equilibrium levels. That means several things. The targets must be real exchange rates, not nominal exchange rates, because inflation differentials have to be offset by currency movements. The rates would of course be stated in nominal terms but the targets have to be real terms. That is necessary *inter alia* to protect hard-currency countries like the Federal Republic of Germany or Switzerland, that have a high anti-inflation bias, against imported inflation.

It will also be essential to install procedures to change the real rates themselves to offset underlying differences in national economic developments, such as productivity differentials. For example, under a crawling target zone system, I would expect the zone between the yen and the dollar to rise by something like 5 percent per year (in nominal terms). Japan will probably run inflation rates of about 2 percent a year less than the United States. Its productivity growth will probably be a couple of percentage points higher. Its huge creditor position and investment earnings, contrasted to the U.S. debtor position and growing interest payments, probably account for another percentage point or so. Keeping the rates in equilibrium is thus going to require something like a 5 percent annual appreciation of the nominal yen-dollar rate, and the system has to comprehend that. It must of course also be able to change rates whenever there are large shocks, such as a major shift in the price of oil.

Third, and critically important, the target zones must be considerably wider than the reference ranges that are apparently now in place. Those ranges have been variously reported as plus or minus  $2\frac{1}{2}$  or plus or minus 5. That is not large enough for two reasons. One is that we cannot know with precision the level of exchange rates that will achieve and maintain current account equilibrium. A wider range therefore provides greater flexibility in trying to achieve those primary purposes of the scheme. The other is that it is important to permit exchange rates to move within the bands in order to permit some continued use of monetary policy to pursue domestic targets, particularly price stability. Moreover, when the currency midpoints have to change, it is important that they do so within the ranges to avoid both market disturbances and political problems.

Moreover, there is no need for a high degree of rate fixity. What we need are rates that avoid the large misalignments and thus large disequilibria of the type that have pervaded the last fifteen years. Target zones could do so.

There is a peculiar view in some quarters that target zones are the same thing as fixed exchange rates. That of course is true only when the exchange rates reach the edges of the zones. In my judgment, they would not do so most of the time—assuming that my initial criteria were successfully met. Even in the EMS, with its much narrower margins, the rates are only infrequently at the actual edges of the zones and thus requiring strong adjustment measures or changes in parities. We need to be clear that target

zones represent an intermediate approach which is very different from fixed rates.

The fourth change that is required is that the participating countries accept a commitment to change their policies when needed to protect the zones. Under the reference range system, as best we can understand it, the only pledge is to consult when the rates move a certain degree away from their midpoints. The credibility of the whole system depends on the willingness of the countries to change policies when the rates reach the edge of the zone.

They may not have to do so very often, as just mentioned, if the initial criteria are met correctly. If the rates had been set at equilibrium levels, and if they are adjusted in advance to avoid the onset of big external imbalances, very little may have to be done. If the officials do have to act, intervention and jawboning would likely be the first points of departure. Changes in monetary policy would come next. On occasion, as now in the U.S. case in particular, changes in fiscal policy would be required.

Here too there is a good deal of misunderstanding. Karl Otto Pöhl of the Bundesbank, for example, has on occasion suggested that "robotization" of policy would be implied by a target zone system.<sup>5</sup> Nothing is further from the truth. Action would be required to maintain rates within the zones, but complete discretion will be left to the government involved as to what kind of action to take. That is one of the most important virtues of this kind of system.

By contrast, the indicators approach essentially tries to set a target zone for everything. In its original formulation, it identified ten variables for seven countries and tried to fill every cell in that seven by ten matrix. The Toronto Summit in 1988 added microeconomic variables, to broaden even further the set of topics on which adjustment discussions should take place. It seems to me that is the wrong approach and is wholly unnecessary. What is necessary is to view the whole range of domestic economic policies, macro and micro, through the lens of the exchange rate. If movements in the exchange rate suggest a need for policy action, steps should be taken on those policies which will effectively achieve the external and internal adjustment which is required.

History tells us that the only effective efforts to achieve policy coordination have occurred when they have been prompted by an agreed exchange rate mechanism. The Bretton Woods system, for all its shortcomings, did work to a significant extent. The European Monetary System is now working to a significant extent. There is no historical case where an effort to coordinate macroeconomic policies directly produced effective results. We should learn from the past and move to an intermediate and pragmatic system of target zones for all the major countries. If we do so effectively, the next twenty-five years of international monetary history can be considerably more successful than the last forty.

<sup>5</sup>See Karl Otto Pöhl, "You Can't Robotize Policymaking," *International Economy* (October/November 1987), pp. 20-26.

## Questions and Answers

*Sir Jeremy Morse:* Thank you very much, Fred, for throwing some firecrackers into the debate, and thanks also to all three speakers for bringing us to where we wanted to be at 4:30. If you have written questions, if you will pass them to the end of the line, the ushers will bring them up. But I'm about to throw the meeting open for general discussion.

All our speakers talked about the exchange rate system, some with forecasts, some with prescriptions. Two of them talked about the balance between the United States, Japan, and Europe. Tommaso talked about coordination and sovereignty, Kit drew our attention to the crucial importance—with which I much agree—of technological change surely going on at the same pace as in the past twenty-five years. I think our speakers all expected the markets to remain much more powerful in settling the system than they were before. I wasn't sure, but I suppose by silence, they're not expecting a return to inflation, and we heard almost nothing about the developing world because we were looking at it from a systemic point of view. So there's plenty to dive into, both what was said and what was not said. I will just stand here to receive the questions and pass them on to our three speakers. Who would like to make the first comment or ask the first question? . . .

The question was will the U.S. correct its external deficit and regain some of the dominant position it had in the past or will that not happen? Fred, you have the first go.

*C. Fred Bergsten:* I could make two comments on Richard O'Brien's question. The first is that I share his hope that the United States will return to current account balance, but that it's going to require an improvement of \$200 billion in our merchandise balance in nominal terms and thus an improvement of perhaps \$250 billion in real terms—6 percent of our GNP. That is a herculean task even before one asks the international question, "what surplus countries are willing to accept the concomitant declines in their surpluses?"

If it does happen, I do not think it would restore American hegemony of the type that Kit McMahon rightly indicated was an underpinning of the Bretton Woods system. The net international debt of the United States will rise to at least \$1 trillion before it could possibly level off even if my \$200 billion swing is achieved and the U.S. stops the further buildup of its debt. Even then, it will be in a historically unprecedented position. Every key currency in history has developed when its country was becoming a creditor

country. No key currency in history has been based on a country which was a debtor country, let alone the world's largest debtor country.

In the outlook for the United States and the dollar over the next ten to twenty years, we do have a historically unprecedented situation. But I do not think the international role of the dollar would disappear. The United States has many economic strengths and virtues, and inertia is a very strong element in international financial affairs. But I think the situation you hypothesize, Richard, of the U.S. going back into surplus, would simply limit the decline of the international role of the dollar rather than restore American hegemony and will still leave us with a need for a new kind of international cooperative management of the system that I was talking about.

*Sir Jeremy Morse:* Thank you. Do you want to add anything, Tommaso?

*Tommaso Padoa-Schioppa:* No, I would have to repeat every word that was just said.

*Sir Jeremy Morse:* Kit?

*Sir Kit McMahon:* I would say something slightly different. I agree with Fred on the terms of the problem—I think the problem is gigantic and near disastrous. I think it's appalling that it has got to this position. It will probably take five years, maybe more to solve. But I would certainly believe that, one way or another—and it might be very bumpy—by the time we get twenty-five years on, this will all be one of many incidents in the past.

*Sir Jeremy Morse:* Thank you. Who is next? Yes please, Dr. Baffi. . . .

Did you all hear the questions at the back of the room? The first question to Fred Bergsten was who was going to administer his new target zone system? Would it be the IMF, a new IMF like Tommaso mentioned, or would it be the Group of Ten or who? The second question was whether a tighter zone of exchange rates like the EMS—how it could live within his broader system of target reference zones? And the third question was particular to the British situation. Would he advise the British Government to wait for his new system before joining the EMS and with a larger margin? Fred, plenty to deal with, and then some others might like to comment after you've had a go.

*C. Fred Bergsten:* With you, Mr. Chairman, and Kit on the platform, I would feel unqualified to try to answer the last question, so I will pass that back to my British colleagues. I'll take a crack at the other two.

Yes, I think the IMF would ultimately have to run the kind of target zone system I'm talking about. I fully agree with Kit McMahon on this point. There is no hegemon, as the political scientists call it, no dominant country likely to be able to do it on its own as the U.K. did in earlier periods and as the U.S. did in the earlier postwar period. It's going to have to be management by committee. That is again something unprecedented, which will have to be worked through, but I think it's the only alternative.

I think one has to view the decision making in this area, like most international areas, as a series of concentric circles. Realistically, the biggest countries get together and work out the initial outlines of an agreement. Then they go out and sell that, or work it out, with their closest associates. And then ultimately it is legitimized in the full international forums of which the IMF is the relevant case here. That happened with the move to floating—rightly or wrongly, that was the technique that occurred—and I think that's the technique that will occur this time. But given the need for international consistency, given the need to make sure that a very large number of countries play by the rules of the game, I think it must be the IMF.

On your second question, I see no necessary inconsistency between a tighter grouping like the EMS and a broader target zone system of the type I'm discussing. We have exactly that kind of a two-track system in the international trade field, where some countries take on a full set of obligations under the GATT rules, and others take on lesser obligations. In the Tokyo Round there were negotiated a series of codes on subsidies, government procurement, and other things, where some countries took more extensive commitments and went further; so I see no inherent contradiction.

What does have to be watched is any conflict between the specific implications of those obligations at a given moment. All of you in the EMS know, better than I, that there have been instances where the intervention obligations under the EMS conflicted with obligations vis-à-vis the dollar and vis-à-vis the yen on the global basis. So the coordination between the two systems would have to be even more intensive than in the past but I certainly see no inherent conflict.

*Sir Jeremy Morse:* Thank you very much. Kit, you've had thrown to you the British question. You might like to comment on the other part, too.

*Sir Kit McMahon:* No, I don't think I would especially. But I would hate to have to wait until Fred's target zone system is implemented to make a decision whether the U.K. should go into the EMS on narrow or wide margins. I'd like it to go in on narrow margins now and see what happened later.

*Sir Jeremy Morse:* If I may add my own point of view. I think that the question about what is the right rate or the right system of rate to join is always to me irrelevant. If you belong to a club, you should be in it and fully in it and getting on with it, for political rather than economic reasons. Next question, please. . . .

How do we see the provision of development finance to the developing countries in the future twenty-five years because the present or the previous system seems to have broken down? Who would like to have a first go at that? Tommaso?

*Tommaso Padoa-Schioppa:* I think that the subject on which we have concentrated so far leaves in a sense as separate the problem of development

finance. One could imagine that if the system developed along the lines that some of us have tried to indicate—the very strong connection between the conception of the international monetary system and this development finance dimension—this strong connection will become in a sense looser. The function of preserving monetary order in the world would regain importance as a function that is distinct from the function of development finance. For that second function, which would be a subject for another discussion—one could imagine improvements in arrangements—but I think the two subjects are separate.

*Sir Jeremy Morse:* Kit, will you have a go?

*Sir Kit McMahon:* No, I don't feel competent to set out a way in which development finance would be increased. I think it is somewhat separate from the international financial system and I think it depends on a lot of more political will, coordinated political will than we have. But, again, in terms of the way I see the world going over a longer period, I would expect that Japan would, in fact, play a much bigger role in development finance. I'm not saying just that they should, I'm saying that they *will* play that much bigger role. But I'm sure there would need to be a strengthening of the World Bank, and I think that this can be done regardless of what's happening to the international monetary arrangements. Fred?

*C. Fred Bergsten:* I think the evolution of development finance over the next generation has to proceed along two tracks. The first is a much greater role for the public international institutions—the World Bank and the regional banks. Before the first oil shock, the flow of resources from the industrial to the developing world was about three quarters public and one quarter private. Within the private component, three quarters was direct investment.

After the first oil shock, the ratio reversed. It became three quarters private, of which the great bulk was commercial banks, and only one quarter was official. I think we have to move back to, again, a Hegelian synthesis—I seem to like those today—of something like fifty-fifty, with a much bigger share for the public institutions, on the one hand, and, within the private lending, a much bigger role for the nonbank lenders. There's going to have to be a whole series of institutional changes and policy changes, importantly in the host developing countries, to get an increased renewed flow of direct investment and other forms of equity and quasi-equity investments, rather than the bank credits that had been relied on in the past. I think that's both a matter of necessity and a matter of desirability and maybe that should be the topic of next year's Per Jacobsson symposium.

*Sir Jeremy Morse:* But, Fred, I think what you say I couldn't agree with more, that is, what is very desirable to have happen; it is very desirable that we should swing back to fifty-fifty and that we should get more nonbank

finance going, but do you think it is practically likely to happen? And for what policies?

*C. Fred Bergsten:* Indeed I do. The World Bank has just agreed on a sizable increase in its capital that will support a big rise in the Bank's lending program, probably a 50 percent rise in annual commitments and maybe more in disbursements in the next two or three years. The U.S. Congress has not yet ratified, but a sign of the times is that the capital increase has gone ahead already without the U.S. contribution. And the U.S. will come in—it's always late—but the U.S. has always come through. It has never failed to put up a penny of its commitments to the institutions and it will put up for the general capital increase too. So I wouldn't be pessimistic.

But even though we're now seeing a big increase in resources in the World Bank, much more will be needed. Given the fact that the budgetary requirements for supporting the World Bank and the regional development banks are so tiny, for the hard windows, I think the donor countries will increasingly want to put their money through those multilateral channels. The paid-in capital share is now down to 3 percent for the World Bank capital increase, and I think it is headed toward zero in the next one. The need to reconcile budget stringency and the obvious requirement for capital transfers will lead in the direction of more, not less, use of those institutions.

*Sir Jeremy Morse:* Thank you very much. . . .

The general question was to Mr. Bergsten and no doubt to the others. In constructing or forecasting the system of the future, they hadn't said much about the actual structure of the world economy and how it might grow; and, within that, a particular question about multinational companies and whether they would continue to be an important part of it and how they would fit in. Fred?

*C. Fred Bergsten:* Dr. von Planta raises one of the most important issues in this whole area because one of the driving forces behind monetary reform is the fact that corporations are today increasingly looking at the world as their market, whereas governments remain constrained within national boundaries as their domains for policy. And the structural change that you indicate in the corporate world, which is replicated in the financial world, is driving us toward global markets, and it is therefore increasingly anachronistic for national governments to try to manage their economic policies purely on a national basis. It is true that governments retain nominal sovereignty, but real sovereignty has long since disappeared, for exactly the reason you're saying. No government now can control its own economic fortunes purely on a national basis and that goes for the biggest country as well, the United States, as we're now seeing very clearly.

I should have said in my presentation that one of the major reasons for improving the monetary system is to avoid the very misleading and harmful

signals to private enterprise that emerge from the excessive gyration and misalignment of currencies. The *New York Times* recently wrote a story about this topic and asked the treasurers of American corporations whether their investment plans were being motivated by exchange rate changes, and one of them just threw up his hands and said, "I cannot respond to anything as whimsical as exchange rates." When major corporate officials refer to exchange rates as "whimsical," something is wrong. That means, to my mind, we need a new system for exactly the reasons you're saying.

*Sir Jeremy Morse:* Kit?

*Sir Kit McMahon:* I very much agree with the importance—indeed, I referred to it in my presentation—of the proliferation of power, not only in terms of governments, but in relation to the corporations and big banks and in financial institutions. I think it's going to go a lot further and I think it's a very important source of strength to the international monetary system. I certainly also, as Fred does, deplore enormously what has been going on in the exchange rates and would like to see more stability. But, even though sovereignty is being eroded by these big companies and will continue to be eroded, I think it's a long step from that to have a system that will constrain the biggest of all governments to change their fiscal policy appropriately in relation to particular exchange rates. So I think that, in fact, we'll probably be handing more power over to the financial markets, and the financial markets' hedges, and the big corporations' decisions.

*Sir Jeremy Morse:* Tommaso?

*Tommaso Padoa-Schioppa:* I have tried to indicate the two forces that may produce change also in the monetary system. One is trade—developments in the trade area, liberalization of sectors that are not yet liberalized or further integration in sectors that are already open. The second is the business community, which is increasingly international, and where the nationalities, for instance, of the employer and the employee are less and less the same, and create links that did not exist before. I agree that an international monetary system is not an end in itself, but it is precisely because these dynamic elements are at work, that the impulse could come, and if it does, it will come from areas outside the monetary field for a better organization.

*Sir Jeremy Morse:* Thank you very much. . . .

The next question returns to the relationship between the tendency to regionalization that we see in the system and the worldwide system that Fred put forward and indeed the worldwide outlook that the other two speakers also talked about and seems to think that you don't give enough weight to this regionalization. Fred?

*C. Fred Bergsten:* Let me take the occasion to elaborate on the Asian NIEs that Mr. Schwietert raised. I would differ a bit with your characteriza-



tion of the current situation. You suggested that the four dragons were trying to move away from the dollar toward the yen. I read it the opposite way. The problem is that they have *not* been moving away from the dollar toward the yen. Indeed, de facto at least, they have pegged to the dollar. They rode the dollar down against the yen, thereby to some modestly significant extent undermining the Plaza effort to achieve correction of the international payments imbalances.

That pointed up a shortcoming of the system because there was no one in the system who was going to those economies, particularly Taiwan and Korea, and reminding them that they were not playing by the rules of the game. The result was that the United States has gone out and done it bilaterally to a large extent. In the Korean case, the issue was then multilateralized in the IMF and I think that's now on to a better track.

The point reinforces what I said in my remarks. Far from moving toward a yen bloc, those countries have resisted moving away from their dollar peg. I think that's a mistake, in their own interests, but it would be an equal mistake for them to join a yen bloc and peg completely to the yen. What they should do is link to some basket of currencies, with the dollar and the yen having big weights, with some other countries having weights, and maintain their target zone against that weighted average of currencies, reflecting more or less their trade and other international economic exchanges.

I think that will be the developing wisdom in those economies, as in others. That's why I don't see blocs of the type that Kit McMahon was referring to at the outset. More and more countries have moved away from their dollar pegs. I do not see countries moving toward yen pegs. I do see a more pluralistic system in terms of holding of reserve assets, baskets to which countries peg, and within that, maintaining the kind of exchange rate arrangements that I talked about.

*Sir Jeremy Morse:* Kit?

*Sir Kit McMahon:* Could I just use the answer to the question to say something to Fred. I did say in my talk that if this had been 1963 we would have been discussing the overrigidity of exchange rates, the need for more international liquidity, and the problem of gold. I do think that questions of whether or not the newly industrializing economies are hanging on to the dollar or moving up and getting to the yen is very much a 1988 question. It does not seem to me to be at all likely to have any bearing one way or the other on what we will have got to in the first and second decades after the year 2000. And I share in the immediate concerns if we were asked what we should do in the next two or three years. I think I'd have no difference with Fred on that. My concern is over time, as to what evidence we have that major countries will actually, when they've got all these reference zones and all these figures, etc., whether they *will* constrain themselves in a serious way. And I suggested all the evidence—including, most dramatically,

August 1971—suggests that this kind of constraint is not given, not imposed by a system, only imposed by extremity or negotiation.

*Sir Jeremy Morse:* Yes, Alexandre Lamfalussy? . . .

The next question is what will be left for the sovereignty—which Kit thought would continue to be a very powerful force—in a world of absolutely free capital movements and in a world of instantaneous information. And perhaps, I might here read, Kit, a written question which is somewhat on the same lines but adds other reasons why they think that *de facto* sovereignty will be difficult to maintain. It says: “The pan-European institutional changes and the removal of exchange controls”—that’s partly your same point—“in Europe will surely make it far more difficult to run coherent, individual monetary policies in the European countries and given this possibility of *de facto* surrender of sovereignty, won’t we be forced to go for a European currency?”

*Sir Kit McMahon:* If I may say so, I think that is a very interesting question which I did think about a little and I’ve tried to say a little more about that paradox in my longer written remarks. I think there’s all the difference in the world between *having* less power and *giving* power up. And I think that it is going to become more complicated for countries, they’re going to be more frustrated by the big capital movements, because in my view (and I think we all probably share this view) capital controls are probably a thing of the past for major countries, or soon will be. It is going to be very hard to exercise power in that area even for a government which wants to do so. But there still will be a very large field of operations—for example, fiscal policy and a number of other internal policies—where I would guess—I could be wrong—countries will continue to cling to sovereignty. They will be forced, the closer they link together, as in Europe, to do more and more cooperation, I agree with that, especially in relation to monetary policy. There’s a lot now and there’ll be more. What I don’t see them doing is making the jump to the point of actually allowing their national currency to be submerged into the ECU whose rate of growth is determined by a common decision. To take another field—I think it would’ve been easy to predict fifty years ago that with the spread of communications and the much greater use anyway of English, of one language, that these pockets of small language problems would disappear as national issues. What we observe is the reverse, actually. It may not make much sense to me for the Welsh to want their own language and some sort of a national identity. But I observe they want it and they’re wanting it more and more.

*Sir Jeremy Morse:* Tommaso?

*Tommaso Padoa-Schioppa:* Well, I agree with the *sous-entendu* of Alexandre Lamfalussy that very little is left of sovereignty in the conditions he describes. I also agree that to have less power is different from giving up

power. Where my European experience leads me to conclusions that are different from those that may be reached looking at a wider situation is that in Europe we do have continuously formal concessions of an institutional type whereby sovereignty is put in common. The process that now leads to the integration just in the financial sphere, like the process of having full mobility of capital and an integrated financial market, is a process where decisions are taken with a majority vote, which means that any country is ready to be outvoted on these kinds of crucial matters. So, at the regional level, I don't see it as an impossible development. I agree that it is much more difficult worldwide.

*Sir Jeremy Morse:* Fred?

*C. Fred Bergsten:* Alexandre's question is obviously central to this whole debate and I'd like to put a little different twist on the answer. What I'd really like to do is redefine sovereignty. I think we make a mistake when we sometimes say to countries that their choice is between defending their national interests and doing what's in the international interest. I know we make a mistake tactically when we put it that way, but I think we make a mistake analytically as well.

The reason is that, with the world economy now so increasingly interdependent for the reasons Dr. von Planta was mentioning, very few countries can maintain real economic sovereignty for any time at all. I would therefore define sovereignty by trying to instill the notion in policymakers around the world that it is in their sovereign national interest to work out policies that are compatible at the international level because then, and only then, are those policies really sustainable. I get a debate on that when I say it before our congressional committees, as I frequently do, but that kind of understanding and redefinition or synthesis between the previous dichotomization of views has to be increasingly understood because it's the only way to get to a true political answer to the questions that have been raised about the feasibility of all this.

*Sir Jeremy Morse:* I think we have time for one more question before I ask the speakers if they want a last word. . . .

The question follows on the previous discussion and relates particularly to the United States. Does the United States now recognize, particularly in the fiscal policy area, the impact of other countries and the situation of other countries in the world. Fred?

*C. Fred Bergsten:* The simple answer is no, of course, as all too clearly demonstrated by our failure of actions on the fiscal policy front. In fact, I think we may need some structural reforms and I'm pursuing a major project at my Institute trying to figure out what those might be. But let me close with a modest ray of hope. I mentioned briefly in my remarks that I was optimistic that our new government, elected later this year, will finally take constructive action on the fiscal front. I think the reason is purely political,

and it goes back to rational self-interest. When our new president is elected in November, he will wake up the next morning, and like any new president or any leader in any of our countries, think first about getting re-elected four years later. When he gets his economic briefing, it will be pointed out that the U.S. economy is dependent on borrowing \$10–15 billion per month from the rest of the world to keep our economy afloat. If that \$10–15 billion stops coming in at prices that are consistent with our own economic success, his presidency will fail. Indeed, one of our potential candidates decided not to run because he concluded we were going to need another Herbert Hoover before we could have another Franklin Roosevelt. So I have enough faith in the political self-interest of our next government to believe that they will see what folly it would be to try to make it through four more years of relying on foreign financing, and that they therefore will take the fiscal action necessary to get the external deficit down at least to a reasonable level over a period of four or five years.

The fact that our economy is strong makes it possible to do so in economic terms. But I put most weight on the political self-interest of the politicians involved. That is simply to say that, even for the United States, the chickens do come home to roost. The difficult medicine has to be taken, albeit with much too long a lag. And we'll probably need some institutional innovations in the United States to change the way we make fiscal policy, to be compatible not only with parliamentary systems but with the increasing openness of our own economy.

*Sir Jeremy Morse:* Thank you very much, Fred. I think that's a splendid final answer from you. Do either Kit or Tommaso want to say one minute each on anything that you've not had a chance on? Tommaso?

*Tommaso Padoa-Schioppa:* Just two very quick comments on Fred's and Kit's remarks. With Kit I think I entirely agree on the problem of sovereignty. Where I think there may be a difference, and on this point I think I'm the pessimistic one and Kit is the optimistic one—is what will happen if no progress is made in putting sovereignty in common? I think that twenty-five years is too long a period for not having some kind of major failure in the accumulated existing set of trade arrangements in the world without such further progress. On Fred, one point of semantics, target zones are, to my mind, one kind, one formula, for an adjustable peg. So my use of the term “adjustable peg” included target zones. I don't know what the exact rule will be, but it seems to me that the problem is not so much to design a rule as to manage it correctly; a system is made of rules plus practice and Bretton Woods has failed on practice more than on rules.

*Sir Jeremy Morse:* Thank you very much. Kit?

*Sir Kit McMahon:* Well, if I could just make a comment on the other two. I think that Tommaso and I agree very much on our analysis. Where we differ slightly in the end I think is on the possibility of institutional solutions.

With his much greater European experience I would like to bow to him and hope that he is right that there will be more sovereignty given up in Europe than I expect. With regard to Fred, I think there's a bigger difference. I do differ in analysis on a number of things—for example, what happened to Bretton Woods and what constitutes a system and what can make it work or not. But the biggest difference, I think, is that while we have both been in the public sector, he is able, and I admire him, to retain optimism and a prescriptive spirit which I've happily been able to drop. And I think most of our differences are that his remarks are normative and mine are perhaps pessimistically positive. Thank you.

*C. Fred Bergsten:* I would only add, Mr. Chairman, that I was not in the public service as long as Sir Kit, so possibly that explains at least part of the difference between us!

*Sir Jeremy Morse:* Thank you very much. I hope you all feel what I feel that, meeting in this beautiful aula of the university this afternoon, we have had a range of ideas and a forcefulness in expressing them and a clarity that would have delighted Per Jacobsson. And if you have all enjoyed it, please join me in thanking the speakers in the usual way. [Applause.]

And that, ladies and gentlemen, concludes the proceedings. Please be with us if you can at the Per Jacobsson lecture next year at the time of the International Monetary Fund meeting in Washington. Thank you.

## Biographies



**Sir Kit McMahon** is Chairman and Group Chief Executive of Midland Bank. He is also Chairman of Midland Montagu Holdings and a Director of Hongkong and Shanghai Banking Corporation.

From 1953 to 1957 Sir Kit was an Economic Assistant at H.M. Treasury and from 1957 to 1960 Economic Adviser at the British Embassy in Washington, D.C.

Sir Kit joined the Bank of England as Adviser in 1964. He was Adviser to the Governors from 1966 to 1970, Executive Director from 1970 to 1980, and Deputy Governor from 1980 to 1985. From 1978 to 1984 he was a member of the Group of Thirty and from 1980 to 1985 Chairman of Working Party No. 3 of the Organization for Economic Cooperation and Development.

Sir Kit was appointed Deputy Chairman of Midland Bank in April 1986 and Group Chief Executive in September 1986. He assumed his present position of Chairman in April 1987.

In 1986 Sir Kit became an Honorary Fellow of Magdalen College, Oxford. He has been Chairman of the Overseas Promotion Committee of the British Invisible Exports Council since April 1986, Chairman of the European Banks International since January 1987, and a Director of Eurotunnel since March 1987. He was knighted in 1986.

Sir Kit was educated at the University of Melbourne and at Magdalen College. Among his publications are *Sterling in the Sixties*. He also edited *Techniques of Economic Forecasting*.

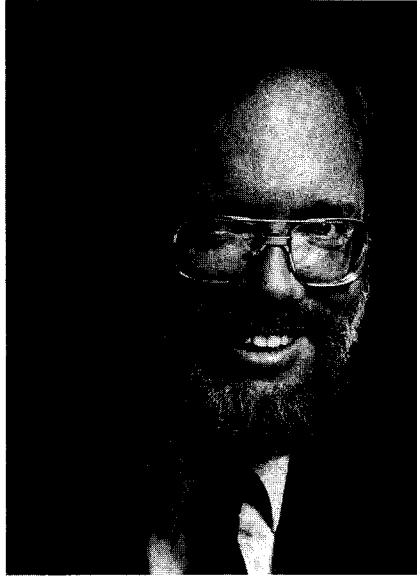


**Tommaso Padoa-Schioppa** is Deputy Director-General of the Banca d'Italia.

From 1970 to 1979 Mr. Padoa-Schioppa worked as an Economist in the Research Department of the Banca d'Italia. In 1979 he was appointed Director General for Economic and Financial Affairs at the Commission of the European Communities in Brussels and a member of the Board of Directors of the European Investment Bank. In 1983 he returned to the Banca d'Italia and was appointed Central Director for Economic Research.

Mr. Padoa-Schioppa is Deputy Chairman of the Banking Advisory Committee of the Commission of the European Communities, a member of the Group of Thirty, and a member of the Board of Directors of the Fondazione Adriano Olivetti.

Mr. Padoa-Schioppa holds degrees in economics from the Luigi Bocconi University in Italy and the Massachusetts Institute of Technology in the United States. He is the author of numerous articles.



**C. Fred Bergsten** is the Director of the Institute for International Economics in Washington, D.C.

Mr. Bergsten was Assistant Secretary of the Treasury for International Affairs from 1977 to 1981 and served as Under-Secretary for Monetary Affairs during the last year of that period. From 1969 to 1971 Mr. Bergsten was Assistant for International Economic Affairs to Mr. Henry Kissinger on the Senior Staff of the National Security Council.

Mr. Bergsten has been a Senior Fellow at the Council on Foreign Relations (1967–68), the Brookings Institution (1972–76), and the Carnegie Endowment for International Peace (1981).

Mr. Bergsten has written numerous books and articles on international economic issues. Among his recent publications are *The United States-Japan Economic Problem* and *Bank Lending to Developing Countries: The Policy Alternatives*.

Mr. Bergsten obtained his M.A., M.A.L.D., and Ph.D. degrees from the Fletcher School of Law and Diplomacy. He has received the Exceptional Service Award of the Department of the Treasury, the Meritorious Honor Award of the Department of State, and the Légion d'Honneur from the Government of France.



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